Confluence INVESTMENT MANAGEMENT

Weekly Geopolitical Report

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The 2022 Geopolitical Outlook

(This is the last* WGR *of 2021; the next report will be published on January 18, 2022. Starting in 2022, we will shift to a bi-weekly publication schedule and will add a new Geopolitical Podcast with each report.)

As is our custom, in mid-December, we publish our geopolitical outlook for the upcoming year. This report is less a series of predictions as it is a list of potential geopolitical issues that we believe will dominate the international landscape for 2022. It is not designed to be exhaustive; instead, it focuses on the "big picture" conditions that we believe will affect policy and markets going forward. They are listed in order of importance.

Issue #1: China

In recent years, people in the world's liberal democracies have increasingly come to see that China under President Xi Jinping is not a model "emerging market" progressing happily within the U.S.-led world order toward political freedom and capitalism. Indeed, a recent survey by the Ronald Reagan Presidential Foundation and Institute found that 52% of Americans now see China as the greatest threat to U.S. national security, up from 21% four years ago and far more than the 14% who see Russia as the greatest threat. As we showed in a series of *WGR*s at the beginning of 2021, Chinese leaders not only want to preserve and strengthen Marxism-Leninism in the country, but they are actively building China's military, economic, and diplomatic power in order to eventually replace the U.S. as the global hegemon.

In 2022, President Xi will take an important step in further consolidating his control over the Communist Party of China (CPC) and the country as a whole. Since becoming general secretary of the CPC in 2012 and president of China in 2013, Xi has used a number of tools to bolster his power, such as anticorruption campaigns to eliminate political rivals, taking control of the Central Military Commission to ensure the loyalty of the People's Liberation Army, getting the party to write his name and philosophy into the CPC's foundational documents, and using propaganda to create a new cult of personality centered on him. At the party's 20th National Congress in late 2022, Xi is expected to be approved for a third term in office, taking advantage of a constitutional change he pushed through in 2018. The evidence suggests Xi is laying the groundwork to remain president for life. With a third term, Xi will solidify his authoritarian leadership over China and decisively break with the collective, consensus-driven decisionmaking norms of the post-Mao years.

Xi must still avoid generating pushback to his rule from the party or society, but his nearly complete control over the CPC and the Chinese government means one man now controls almost 19% of the world's population and 18% of its economy. Still, our research indicates that Xi's goals and strategies are heavily informed by little-known Politburo member Wang Huning. With Wang as his key "idea guy," Xi in 2022 will probably double down on his goal of achieving the "great rejuvenation of the Chinese people," by which he means restoring China to its historical position as the dominant military, economic, social, and cultural power in Asia and globally.

Perceptions matter to Xi, Wang, and the rest of the Chinese leadership. If they continue to see China as the world's ascendant power, and if they continue to see the U.S. and its democratic allies as sliding into political, economic, and social decline, Xi and his government will likely intensify their aggressive policies:

International. Buttressed by Xi's rhetoric about the glorious history of China, the advantages of Confucian culture, and the supposed success of communist economics, China's overarching foreign policy goal in 2022 will be to build Xi's "community of shared future," by which he means a world in which China calls the shots and all other countries follow its lead because of their dependence on the Chinese market. China will continue leveraging its economic power by granting favorable trading terms to friendly countries and companies, while punishing those that oppose it, such as Australia. Even though Xi thinks Chinese rejuvenation requires regaining control over Taiwan, we think the military and economic risks of an outright invasion will preclude him from taking that tack. All the same, he will keep building up the Chinese military, with a focus on nuclear weapons and advanced technologies like hypersonic missiles and autonomous vehicles. He will keep laying the groundwork for foreign military bases and trying to warn off Taiwan from any effort to declare independence. All those initiatives will carry the risk of miscalculation and accident leading to a shooting war, with potentially catastrophic consequences for the global economy and financial markets.

Domestic. At home, we expect Xi to continue clamping down on potential power rivals and risks to stability. A key tool will be his "common prosperity" policy to reduce wealth inequality. That policy may be extended beyond the anti-monopoly, data security, and worker protection initiatives introduced in 2021. For example, the policies may be supplemented by tax hikes on the rich or extended beyond big, powerful technology firms. In addition, Xi will probably continue reining in China's excessive debt, especially in the real estate sector. In each case, the government will likely backtrack as needed to keep from destabilizing the economy. All the same, the continued clampdowns are likely to weigh on Chinese risk assets for the foreseeable future. Given China's big role in the global economy, such clampdowns and the possible slowdown in Chinese economic growth could also weigh on global risk assets.

Issue #2: Russia

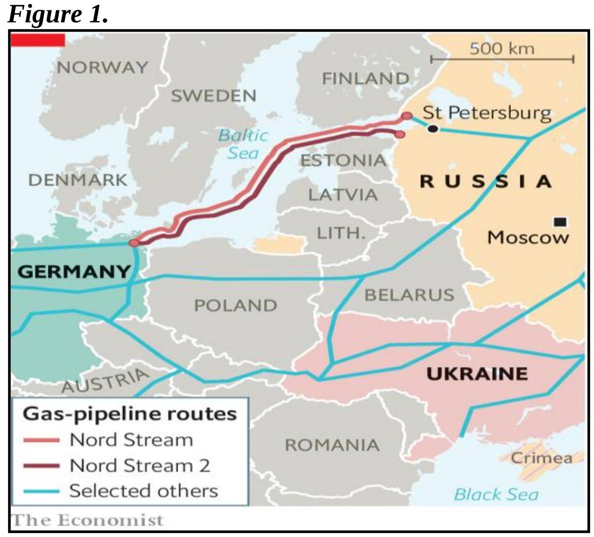
Russia remains a "great power" owing to the nuclear weapons and large military it inherited from the Soviet Union, its petroleum and mineral wealth, and its sizable, well-educated population. At the same time, however, Russia faces a bleak geopolitical future given that its population has stagnated and may soon start to decline. It has also been unable to stamp out corruption, liberalize its economy, or diversify into the higher value-added industries that have become so important to boost economic growth. Russia is rapidly being eclipsed by China, not only economically, but also in terms of geopolitical power.

We believe President Putin and the rest of the governing class, which is dominated by former members of the KGB and billionaire "oligarchs," have adopted a strategy to survive politically and thrive financially by keeping Western countries too off-balance to interfere. At home, they are providing Russian citizens with enough stability and national pride to avoid political pushback and also persecuting opposition politicians relentlessly. In 2022, we believe these strategies will play out in the following key ways:

Ukraine. Letting Ukraine into NATO would clearly cross a red line for Russia and isn't likely to happen soon. Still, the U.S. and other NATO countries have increased their military, diplomatic, and economic support for Kiev in recent years, in what Putin probably sees as a creeping, informal embrace of Ukraine. Putin has therefore put his foot down and is implicitly threatening an attack on the country to exact U.S. and NATO security guarantees. A December video call between Presidents Biden and Putin could help diffuse the issue, especially since Biden subsequently hinted at talks to address Russia's concerns. However, saber rattling and posturing on each side could lead to a miscalculation or accidental outbreak of hostilities that would likely be negative for risk assets but positive for oil and gas.

Energy Politics. To ease relations with Germany and Russia early in his term, President Biden initially acquiesced in the imminent completion of the Nord Stream 2 gas pipeline between the two countries. However, post-pandemic supply woes started driving up European energy prices in late 2021, and it began to appear that Russia was slow-walking its gas deliveries to Europe as leverage to ensure final certification of the pipeline. Biden came under increasingly intense political criticism over his move, especially since the pipeline would hurt Ukraine economically by diverting gas from pipelines crossing its territory and depriving it of transit fees (see Figure 1 below). During his December call with Putin, Biden therefore threatened to stop Russian gas deliveries through Nord Stream 2 if Russia invaded Ukraine. Whatever the outcome, we think Russia and the U.S. could continue to play politics with Europe's energy supplies. That could keep energy prices volatile, at least in Europe, with the associated risk of increased inflation or an economic slowdown.

Figure 1.



Russia-China Relations. There is no formal military alliance between Russia and China, but the two countries have begun to cooperate more closely in order to weaken the Western democracies. Now, China's strong economic growth and technological prowess have been transforming it into the dominant partner. When acquiring Russian weapons, for example, Beijing is increasingly able to demand that they be produced on Chinese soil, which is helping transfer Russian technological know-how. In 2022, we think China will increasingly dominate its relationship with Russia. If so, Russia will become less and less of a geopolitical counterweight to China and more of a facilitator.

Issue #3: Germany

After 16 years under the leadership of Angela Merkel, a center-right politician, Germany got a new, center-left coalition government in December 2021. Even though the new chancellor, Olaf Scholz of the Social Democratic Party (SPD), served as Merkel's finance minister, the coalition between the SPD, the leftist Greens, and the libertarian Free Democratic Party (FDP) promises a significant change in Germany's foreign and domestic policies.

Foreign Policy. We think the Scholz government will ally itself more closely with the U.S. than that of Merkel, who prioritized protecting German industrial interests in China, Russia, and the rest of Europe. With Green co-leader Annalena Baerbock as foreign minister, Germany will probably take a tougher line against China and Russia regarding their human rights records and geopolitical aggressions. For example, Scholz's coalition deal indicates Germany will freeze a proposed EU investment treaty with China. That could help strengthen the U.S.'s hand in countering China's geopolitical moves and incentivize Beijing to moderate its foreign policy. Within Europe, the government has signaled it will support some loosening of the EU's stringent fiscal rules, backing away from the painful austerity measures that Merkel's government imposed on highly indebted countries in southern Europe a decade ago. Modest fiscal loosening in those countries could help broaden European economic growth and give a boost to European equities. At the same time, the government has signaled it will push the EU to take a tougher stance on Poland and Hungary for their policies undermining the rule of law.

Domestic Policy. With Green co-leader Robert Habeck serving as both vice chancellor and minister of the economy and climate, the government's domestic focus will be on boosting investment to produce more green energy and cut carbon emissions. Reflecting the demands of FDP leader Christian Linder, who serves as finance minister, the coalition deal promises to reimpose a constitutional debt limit suspended during the pandemic. Scholz and other government members have signaled they will find workarounds that will have the effect of loosening German fiscal policy, but we suspect any such loosening will be modest. Overall, we expect only limited fiscal loosening in Germany, while overall policy supports stability. The result would likely be moderately positive for European equities, fixed income, and the euro.

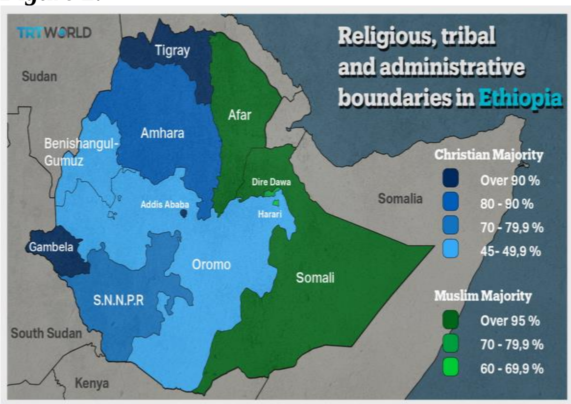
Issue #4: The Crisis in Ethiopia

Ethiopia has a troubled history. In 1974, the Ethiopian empire ended; it had lasted a long time, running from 1270 to 1974. A coup ousted Haile Selassie and military leaders declared a Marxist-Leninist state. This government faced nearly constant crises, with the principal issue being persistent civil conflicts and famine. Even the institution of a civilian government in 1987 didn't resolve tensions. The Ethiopian Marxist government was dependent on the U.S.S.R. and its Eastern European client states for aid. When the Soviet Union collapsed in 1991, the Marxist government lost its source of aid and fell to the Ethiopian People's Revolutionary Democratic Front (EPRDF), a coalition of groups who were unified by the goal of ousting the government; unfortunately, the group didn't have a common vision for the country.

In 1991, after years of attempting to separate from Ethiopia, Eritrea became independent. The country had existed before, but in 1962, it was annexed by the Ethiopian Empire; thus, Eritrea had a separatist movement from the time it was incorporated into Ethiopia and achieved independence almost three decades later.

To understand the constant unrest in Ethiopia, it helps to understand the tribal and religious divisions.

Figure 2.



(Source: TRTWorld)

In 2004, the EPRDF leader and PM Meles Zenawi tried to federalize the government structure based on tribal affiliation. The plan was fostered by the Tigray People's Liberation Front (TPLF), which dominated the EPRDF. Although the goal was to create conditions that would support democracy, in practice, the Tigray tended to dominate the government. Zenawi died in 2012 and was replaced by Hailemarian Desalegn. He left office in 2018 for the current PM, Abiy Ahmed.

Abiy received the Nobel Peace Prize in 2019 for signing a historic peace agreement with Eritrea, ending a 16-year conflict. However, tensions within Ethiopia remain elevated. In November 2020, Abiy started a campaign against the Tigray, which has gone against the government. Tigrayan forces have routed the Ethiopian military and are threatening to overrun the capitol city, Addis Ababa. The war has led U.S. Secretary of State Blinken to visit the country to try to prevent a wider conflict.

There are three issues of concern. First, other nations in East Africa, including Eritrea and Sudan, could become involved, leading to a regional war. Second, China has investments in Ethiopia as part of its Belt and Road Initiative, and may become involved to protect those investments. And third, Ethiopia has started to fill the Grand Ethiopian Renaissance Dam at the headwaters of the Blue Nile. This dam will give control of flows to Sudan and Egypt, and both nations are profoundly worried that Ethiopia will use the dam to the detriment of the other users of Nile waters. Instability could prompt Egypt to use military force to protect what it sees as its water rights. Thus, the civil conflict in Ethiopia could easily spiral into a regional war.

Issue #5: Rising Food Prices

The Food and Agriculture Organization (FAO) of the U.N. has the task of facilitating global food security. In that role, it monitors world food prices. Its indexes of prices are indicating a growing problem with food security.

Figure 3.

(Source: FAO)

The deflated price series suggests that food prices are at levels not seen since the mid-1970s, when crop failures in the communist bloc and the oil crisis led to rapid price increases.

Although high food prices don't, on their own, trigger geopolitical events, they often become contributing factors. When food prices steadily rose from 2005 to 2010, it supported unrest that was part of the Arab

Spring, which led to political turmoil across the Middle East.

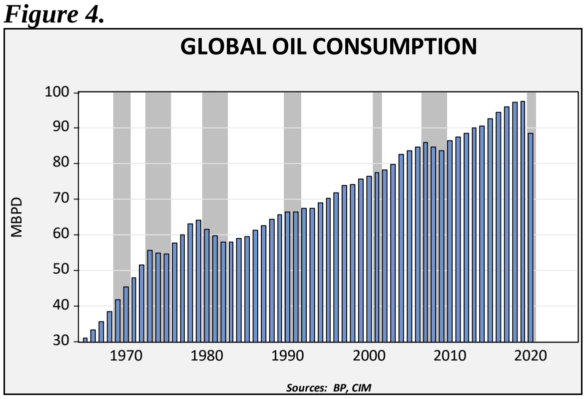
Our concern in the current situation is that food insecurity and rising prices may trigger widespread refugee problems. Afghanistan, for example, is experiencing famine conditions. As conditions deteriorate, the risk of Afghans fleeing the situation to nearby nations and beyond increases significantly. Refugees have been weaponized by some states, such as Belarus and Turkey, and increased food insecurity will likely exacerbate the problem.

Issue #6: The Energy Transition

The world appears to be moving away from fossil fuels. This action will foster important changes in global geopolitics.

The oil industry has generally been able to count on rising consumption.

Figure 4.



Although consumption often declines during recessions, these drops are cyclical and temporary. That probably won't be the case going forward. Competition from other fuel sources and demand restrictions are expected to, at best, lead to flat demand growth and, over time, falling demand.

That may not necessarily lead to lower prices, however. Oil is a depleting asset; producers must constantly drill and explore for oil to maintain current production and to grow supplies. But, in a world of uncertainty, investors may be reluctant to commit capital to an industry expected to shrink. Only producers less sensitive to investment flows, such as the state-owned oil companies of the OPEC+ nations, may invest to maintain output. These nations, paradoxically, may gain a windfall as competition lessens from market economy oil producers.

In addition, nations and companies involved in the transition away from fossil fuels, especially those supplying strategic metals, could benefit. China dominates the rare earths metals necessary for batteries and the magnets in wind turbines. Copper, cobalt, and lithium are all important today, but may not be in the future.

The key point is that there will be serious dislocations caused by the transition away from fossil fuels, and the path won't be seamless. For a time, the major oil producers could benefit from elevated prices and less competition. But, eventually, the petrostates face a dismal future unless they diversify their economies.

Other nations may benefit. Those providing the raw materials for energy transition will likely see demand rise for their products. These changes will affect geopolitical relationships. For the world in 2022, these issues will likely not be in the forefront but will become growing issues over time.

Issue #7: The Failure of the Iran Nuclear Negotiations

Iran and the U.S. will likely be unable to strike a deal to return to the Joint Comprehensive Plan of Action (JCPOA), commonly referred to as the Iran nuclear deal. Iran's demands are not politically feasible for the U.S.; Tehran wants the U.S. to roll back sanctions as a precondition to talks and also wants a guarantee that a future administration could not make changes to the deal. The U.S. can't deliver on either of these demands.

If a deal isn't made, the U.S. and the region must decide how to react to a nuclear Iran. We suspect the Israelis will consider disrupting Iran's nuclear industry, either by covert, or if these fail, overt actions. The U.S. wants to reduce its commitments to the Middle East so it can focus on China, but Iran could destabilize the region and make it difficult for the U.S. to exit.

Odds and Ends

This section is for concerns that may affect the world in 2022 but didn't rise to the level of an issue on our list.

1. Uruguay is attempting to negotiate a free trade deal with China. Not only would that raise concerns in Washington about Chinese influence in South America, but Uruguay is a member of Mercosur,[1] and by the rules of that group, Uruguay can't make a trade pact with China without approval from the rest of the members. China is Uruguay's second largest trading partner after Brazil and may leave the group to make this deal with China. If Beijing is able to complete this pact, it is possible that Mercosur will come along as well, increasing China's influence.
2. Turkey is dealing with severe economic turmoil and may spiral into hyperinflation. As economic pressure mounts, we may see President Erdogan threaten to push Syrian refugees into Europe in order to extract payment from the EU.
3. Lebanon is rapidly becoming a failed state. If the government collapses, the region could tumble into a civil war.

Ramifications

As noted earlier, we don't view these issues as exhaustive, but they do represent the concerns we will be most closely watching as the year progresses. Readers can monitor our reports throughout the year for updates.

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[1] Members include Argentina, Brazil, Paraguay, Uruguay, and Venezuela (the latter has been suspended since 2016).